CMA STRATEGY TO EXPAND THE AVAILABILITY OF FINANCIAL INSTRUMENTS

EGYPT FINANCIAL SERVICES PROJECT
TECHNICAL REPORT #56

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ACRONYMS

AI	Appraisal Institute
ABS	Asset-backed Securities
BDA	Bond Dealers Association
CAPMAS	Central Agency for Public Mobilization and Statistics
CASE	Cairo and Alexandria Stock Exchanges
CBE	Central Bank of Egypt
CMA	Capital Market Authority
CRA	Commercial Registry Authority
CTO	Cognizant Technical Officer
EAA	Egyptian Appraisers Association
EBA	Egyptian Bankers Association
ECMA	Egyptian Capital Market Association
EFS	Egypt Financial Services project
EHFC	Egyptian Housing Finance Company
EIMA	Egyptian Investment Management Association
EISA	Egyptian Insurance Supervisory Authority
EJA	Egyptian Judges Association
ELA	Egyptian Lawyers Association
EMBA	Egyptian Mortgage Brokers Association
ESA	Egyptian Survey Authority
EREA	Egyptian Real Estate Association
ERESA	Egyptian Real Estate Surveyors Association
EYBA	Egyptian Young Bankers Association
GAFI	General Authority for Free Zones and Investment
GOE	Government of Egypt
IFS	International Federation of Surveyors (Egypt Chapter)
IPF	Investors Protection Fund
KRA	Key Results Area
MBA	Mortgage Bankers Association
MCDR	Misr for Clearing, Depository, and Registry
MFA	Mortgage Finance Authority
MOF	Ministry of Finance
MOH	Ministry of Housing
MOJ	Ministry of Justice
MOI	Ministry of Investment
MLS	Multiple-listing Service
MSAD	Ministry of State for Administrative Development
MOU	Memorandum of Understanding
NASD	National Association for Securities Dealers
NIB	National Investment Bank
PDS	Primary Dealer System
PD(s)	Primary Dealer(s)
PGF	Payment Guarantee Fund (Guarantee Fund)
PIN	Parcel Identification Number
SEC	Securities and Exchange Commission
SII	Securities and Investment Institute
UCD	Universal Cadastral Database
UNCITRAL	United Nations Commission on International Trade Law
USAID	United States Agency for International Development
YEBA	Young Egyptian Bankers Association

EXECUTIVE SUMMARY

On 15 May 2006, National Association of Securities Dealers (NASD) advisors Molly Bayley and Michael Kulczak completed their three-week assignment 24 April to 15 May 2006) jointly with the Task 3 EFS long-term team, Ahmed Hussein, Shamsnoor Abdel Aziz and François Pépin, to propose to the CMA a strategy for the expansion of financial instruments in the capital market, as a source of non-bank finance, concentrating on GOE and corporate debt securities, commercial papers, and investment funds.

Laws and regulations were reviewed; annual reports, the CMA strategy, and market data were gathered, analyzed and reconciled; meetings were held with CMA, MOF, CBE, CASE, MCDR, ECMA, EIMA, large corporate issuers, banks, brokers, dealers and PDs, underwriters, investment advisors, and investment funds sponsors.

While noting the remarkable development successes of CMA, CASE, MCDR and the legal framework, two major themes emerged: first, the uneven “regulatory playing field” on which banks and securities companies compete in all of the Primary Dealer system, the secondary Government of Egypt (GOE) bond market, the primary and secondary corporate bond market, and mutual funds; and second, the need for regulators to coordinate their actions to address regulatory gaps in the securities industry, and to adopt a policy of “regulation by function”, because without remedial action, securities firms and the market will simply remain as they are.

The report proposes the expansion of current instruments as a priority over the introduction of new ones, such as commercial papers, convertible bonds, Exchange Traded Funds, Real Estate Investment Trusts (REITS) and financial derivatives which are cautiously kept aside for the time being. The report offers an assessment and a strategy for each instrument, complemented by specific implementation recommendations. The report also proposes steps to be taken to address the two main issues, and discusses ancillary issues such as a public rulemaking process, the pursuit of the Self Regulatory Organization (SRO) agenda, and public awareness.

Prior to the NASD advisors leaving, the entire team met with the CMA Chairman, his Deputy and advisors, to present a summary of the findings and recommendations to be found in the report. These findings were well received without comments for the time being other than a request to EFS to prepare an implementation plan. Accordingly, the report will be presented to the CMA the following week for review, finalization, and acceptance, followed by an implementation plan to be determined, with Task 3 assistance.

The issue of regulation by function, the jurisdictional gaps, and the role of banks in the capital market were brought by NASD’s Molly Bayley and EFS François Pépin to the specific attention of the EFS COP, as these entail various reforms that could require project support and resources at a high level.

SECTION I INTRODUCTION

The USAID-funded EFS contracted with two advisors, Michael Kulczak and Molly Bayley, from the NASD to work with CMA on developing a strategy for the introduction of new financial instruments. Both advisors from the NASD have extensive experience in securities market regulation and operations both in the United States and internationally. The NASD advisors collaborated with the EFS Task 3 long term advisors on this Task. In this Report, the combined effort is referred to as the NASD/EFS Team or simply "Team".

The three-week task (April 24 to May 15 2006) involved reviewing background documents and conducting interviews with representatives of principal institutions and market participants for the purpose of identifying potential for new financial instruments in the following categories:

- Corporate bonds
- Government bonds
- Investment funds
- Money market instruments
- Financial derivatives

For instruments that are currently exist, such as bonds and investment funds, the Task Order directed the Team's focus to identifying how to improve these products and how they are traded in order to create a more active secondary market. In the case of new products, the interviews helped ascertain interest in them and issues that needed to be addressed in order to introduce them to the Egyptian market.

Interviews were conducted with key government officials from the CMA, the MOF, and the CBE, executives from CASE, MCDR, EIMA, and ECMA, and active participants in the markets, including, issuers, bond dealers, primary dealers, underwriters, and mutual fund sponsors, brokers, public companies, investment managers, and banks.

This document summarizes the Team's research findings and recommendations in four sections. Section II highlights certain important achievements in the Egyptian capital market to date. Section III covers the Team's analysis and strategy for each of the existing products and the Team's recommendations. The same section also discusses new products and provides an assessment of the capacity of the CMA, market participants and the market infrastructure to use these products. Section IV provides a strategy for CMA to address the most important recommendations to activate the secondary market in Treasury bonds, corporate bonds and investment funds. And, finally, Section V presents a series of ancillary findings and recommendations which the Team believes add context and policy guidance to the recommendations in Section III.

NASD Advisors are grateful for the willing and expert assistance provided by the staff of the EFS Project and by the openness and responsiveness of the CMA staff in providing direction and critical information on the existing instruments. In addition, the willingness of many executives at regulators, market participants, companies and other institutions to share their time and knowledge was indispensable. Many of these individuals made it a priority to carve precious time out of their busy schedules to meet with the Team. Without the cooperative spirit of all involved, this report would not have been possible.

SECTION II ADVANCES IN THE EGYPTIAN CAPITAL MARKET

CASE has recently improved its rules, and MCDR settles transactions in a totally dematerialized environment and in beneficial owner names, on a T+2 settlement period and without settlement defaults. Above all, both have proven most capable of handling the impressive increase in trading and settlement volumes in 2005 and 2006, without any interruption or disruption to the market.

The CMA was recently re-structured along the lines of a pure securities regulatory agency, and still takes the lead on numerous developments, e.g., an Investor Protection and Insurance Fund, day-trading, margin trading, short selling, asset-backed securities issues, and the pursuit of the SRO agenda.

The MOF has introduced the Primary Dealer System (PDS) for Government debt securities, an auction system for GOE securities setting a real market interest rate, a dematerialized T-Bills registry at the CBE, and dematerialized treasury bonds at the MCDR.

In addition, the market's legal foundation rests on the Capital Market Law, as well as on specialized laws and regulations addressing bond dealing, the PDS, and securities depository and settlement functions.

All these elements contribute to maintain investor confidence, and demonstrate that the market infrastructure is capable of assuming the challenge of expanding and introducing new financial instruments.

SECTION III ANALYSIS AND STRATEGY BY PRODUCT

A. Existing Products

1. Corporate Bonds

A. General Description of Existing Environment

The corporate bond market in Egypt is relatively small having only 23 issues outstanding and listed on CASE at year end 2005. Of these, 12 offered a fixed rate and the remainder, floating rates. Measured against the CASE's total market capitalization, corporate bonds accounted for 1.3% (LE 6.4 billion), and government bonds 9.0% (LE 45.9 billion) at year end 2005. As a practical matter, the maximum term for corporate bond offerings in Egypt is 5-7 years. This circumstance reflects the lack of a well-developed yield curve for Government of Egypt (GOE) bonds with tenors beyond 10 years. It also reflects the preference of local investors for GOE

bonds and deposit products that offer slightly lower interest rates and virtually no default risk.

Based on interviews with underwriters and corporate bond issuers, the NASD/EFS Team learned that even “blue chip” Egyptian companies seeking to issue bonds with maturities of 10 years or more have to go abroad to do so. In such cases, the corporate issuer must borrow and repay the bonds’ principal and interest in a foreign currency. The resulting currency risk can be mitigated, but the issuer incurs an added cost to do so. This is mainly due to absence of a reliable benchmark for yield on bonds of such long term.

The underwriting of corporate bonds in Egypt is dominated by the commercial banks. This activity is carried out directly by the bank and without the necessity of an affiliated broker or obtaining an underwriting license from the CMA. This situation exists even though the operable provisions of the Capital Market Law (CML), Articles 27-28, provide that companies engaged in underwriting must have a CMA license. These provisions are silent, however, as to whether banks are exempt from this licensing requirement.

The Team was advised of the following conventions and practices involving the underwriting of corporate bonds by Egyptian banks:

1) The bank often views the underwriting of a corporate bond issue as an extension of its lending business to a well-regarded customer; the bank may even counsel an issuer to pursue a bond offering to avoid the bank’s running afoul of loan concentration limits established by the banking laws;
2) The bank will only underwrite bonds on a “best efforts” basis even though the Egyptian securities law requires that bonds subject to a public offering have an investment grade rating (i.e., a rating no lower than BBB-);
3) The bank does not commit to support liquidity in the secondary market following the distribution;
4) The bank will normally take down a sizable portion of the bond issuance (10% or more) for its own investment account and hold the bonds to maturity; this occurs even when the bond offering is oversubscribed;
5) The bond issue will be listed on CASE, thereby qualifying the holders for a tax exemption on interest payments and potential capital gains;
6) The minimum public security holder requirement for the CASE listing is sometimes met by the issuer recruiting a group of employees to hold one or two bonds apiece; and
7) One major bank that was active in underwriting corporate bonds conceded that it had never done an equities offering, thus reinforcing the observation noted in point (1).

Following are the details of a recent offering that illustrates the practices of three local bank engaged in underwriting a bond offering for a prominent, CASE-listed company.

Orascom Telecom has issued a L.E. 700 million bond in 2005, of which 30% (L.E. 210 million) was offered to the public. The issuer has used 3 underwriters for this bond issue (Banque Misr, National Bank of Egypt and Bank of Alexandria). The following table shows the subscribers in the public offering.

Orascom Telecom Bond

Subscriber	No.	Amount L.E. Million	%
Banque Misr & its investment funds	2	17.80	8.5
National Bank of Egypt & its investment funds	5	38.20	18.2
Bank of Alexandria	1	4.30	2.05
Staff of Orascom Telecom	99	0.1	0.05
Institutional Investors	12	143.70	68.4
Individual Investors	43	5.90	2.80
Total	162	210.00	100

The above table shows that the three underwriter banks and their sponsored funds have subscribed for 28.75% of the public offering. Twelve other institutional investors have subscribed for 68.4% of the offer. To complete the minimum number of bondholders required for listing on CASE and obtain tax exemption, the issuer has used 99 nominees from its employees to subscribe for 0.05% or 10 bonds each.

From the issuer's standpoint, the NASD/EFS Team learned that banks are perceived as a "trusted source" of capital via credit extension. Issuers' general managers and financial officers are comfortable dealing with banks and tend to develop long-term business relationships with them. As such, most large issuers may not be inclined to make rigorous cost-of-capital computations to decide whether it is better to borrow from the bank or tap the capital market via bond (or equity) issuance. Further, banks have been known recently to make "below market rate" loans to prime borrowers to discourage their looking to the capital market for financing on a major project.

At least one issuer complained about the overall cost and time consumed to conduct the public offering of a bond in Egypt. In particular, this issuer highlighted the length of time and the cost associated with obtaining a bond rating from the lone rating agency operating in Egypt. Apparently, the time and cost factors do not vary even when the issuer has previously issued bonds in Egypt and abroad.

With regard to the secondary market for corporate bonds, they are traded on CASE, cleared, and settled at MCDR. The secondary market for bonds is illiquid, and the CASE order-driven trading system is not well-suited to the efficient trading of these bonds. Several market professionals interviewed by the NASD/EFS Team stated that market makers were definitely needed to provide liquidity to the corporate bond market (as well as the secondary market for government bonds) supported by CASE.

B. Identification and Analysis of Impediments to Product Growth and Market Efficiency

(1) Promoting Growth of the Product

As with government bonds, corporate debt distributed via public offerings provides Egyptian investors with a reasonably safe alternative to investing in corporate equities. Receipt of tax-exempt interest payments along with the opportunity for possible capital gains when prevailing interest rates decline are the principal economic benefits accruing to potential investors in corporate bonds. The fact that these bonds must be rated investment grade to qualify for a public offering is a further selling point for investors seeking a conservative investment vehicle. Likewise, interest rates on corporate bonds are typically higher than simple bank deposit products found in Egypt. In the future, as the bond market matures, issuance of non-investment grade bonds (perhaps only to institutional investors) may become feasible.

Given the dominance of banks as underwriters of corporate bonds, it is doubtful that this sector of the capital market will experience significant growth in the near future. Essentially, banks do not have an economic incentive to promote a corporate customer's use of a debt offering unless there is some compelling reason why the bank cannot accommodate the corporation by direct lending. In short, the banks have no incentive to compete with themselves.

To break this deadlock, the non-bank underwriting community—consisting of at least 30 firms licensed by the CMA—must be motivated to make the economic case for corporations to lower their cost of capital via debt offerings. Analysis of some of the most recent offerings could provide useful insights as to the relevant economic factors. At the same time, the CMA should scrutinize its public offering rules with a view toward streamlining the process, particularly for companies that have equities already listed on the CASE, that have a record of clean " opinions" on their audited financials for the past several years, and that consistently meet the filing deadlines for periodic financial disclosures. It is also possible that ECMA and CASE could jointly produce an economic study that would educate issuers on the benefits of a public debt offering.

If it has not already done so, CMA should examine the operations of the lone company that it has been licensed as a rating agency. In particular, CMA should look at the cost drivers for this entity and its business plan to determine if the rating agency can generate revenues from other business services based on the analytic skills and data used to produce bond ratings. The objectives of this review are to identify ways of lowering the costs of producing bond ratings and expediting the process of providing them to potential bond issuers. The CMA may also reconsider the existing regulations on rating agencies which require the rating to be the sole business of a licensed company. The objective is to attract more companies to this business to promote competition.

(2) Increasing Liquidity by Launching Market Making

Several interviewees observed that the existing market for corporate debt on CASE needs market makers to facilitate price discovery and liquidity. Although the introduction of market makers must await CASE's migration to a hybrid trading system, it is not too early to begin recruiting a committee of interested brokers to spearhead this effort. Their initial task would be to draft the basic requirements for

market makers, including requirements for minimum quotation size/value, the necessity for quoting two-sided "firm" markets, maximum spreads, handling of clients' limit orders, and an appropriate short sale rule. The proposed advisory committee could be sponsored by ECMA or CASE. Among other things, this initiative would open a new business opportunity to the CMA-licensed members of the CASE.

A major incentive for this development could be the CMA's amendment of Article 90 of the Executive Regulations of the Capital Market Law (CML Executive Regulations) to create an exemption for brokers that commit to make markets in corporate bonds. At the same time, the CMA could revise Chapter 7 of the CML Executive Regulations on bond dealers to license the subset of brokers who are willing to make markets in corporate bonds. These amendments should be consistent with the definition of market making obligations and related conventions defined by the ECMA or CASE advisory committee.

(3) Increasing the Float Available for Secondary Market Trading

Several interviewees familiar with the primary market for corporate debt in Egypt confirmed the practice of bank underwriters taking down large segments of debt offerings (i.e., 10% or more), and holding those positions until the bonds mature. This practice is bound to have negative effects on secondary market trading and pricing of individual bonds. This practice is particularly troubling in the circumstance where the public offering is oversubscribed several times. Although this practice apparently is not illegal in Egypt, it certainly undercuts the fundamental concept of a public offering, namely, to achieve the widest possible distribution of the securities being offered. The takedown practice also gives rise to potential conflicts of interest between the underwriter, and its corporate client, as well the investors seeking to acquire bonds through the public offering.

One explanation offered for the banks' takedown practice is that many banks have large portfolios of non-performing loans (NPLs) and substantial amounts of customer deposits. Until the NPLs are "worked out", the banks are investing customer deposits in bonds (corporate and government) instead of expanding their loan portfolios. This strategy produces tax-free income to the banks while avoiding potential exposures from new credit extensions.

Nonetheless, if the market participants and CASE wish to activate secondary trading in the corporate bond market, some means must be found to free-up the corporate bond holdings that have been accumulated by banks through their takedowns. One possibility, which would likely require rulemaking by the CBE, would require banks holding 10% or more of the float of a CASE-listed bond to commit to make markets in that bond when CASE launches its updated trading system. This requirement should be fulfilled through a CMA-licensed intermediary, whether affiliated with the bank or an independent broker that contracts to make markets and split profits (and losses) with the bank.

In sum, the success of efforts to activate secondary market trading in corporate bonds will hinge on increasing the amount of bonds available for trading. The best source would appear to be the bank underwriters.

(4) Halting the Artifice of Using Nominees to Qualify Bonds for Listing on CASE

One scenario explained to the NASD/EFS Team involved the underwriting of a corporate bond by a bank and the use of "token" bondholders or nominees, usually

employees of the issuer corporation to meet the minimum holders' requirement under the CASE listing rules.

As the national securities exchange of Egypt, CASE assumes a legal responsibility for the integrity of the marketplace that it operates. That integrity is grounded on the exchange's enforcement of various rules dealing with access to the market facilities. If those rules are not enforced consistently, the integrity of the CASE and its management will be called into question.

The NASD/EFS team understands that CASE has ample legal basis to reject an application for listing based on finding that the issuer has not acted in good faith. Therefore, if CASE has reason to believe that an applicant is using nominees with small holdings to meet the threshold requirement, it should investigate the matter to confirm its suspicions and promptly refer the matter to CMA for possible enforcement action. If this happens two or three times, the CMA's enforcement action should send the appropriate message to issuers.

Curbing the practice of using nominees will compel issuers to choose whether they want a private placement or a genuine public offering of their bonds. This decision should limit the listing of bonds on CASE to those instances where the issuer (and its underwriter) intend to make a *bona fide* public offering. Furthermore, to better define the CMA's regulatory policy, the Team recommends that the CMA develop of a code of corporate finance regulations that would clearly define, among other things: (1) what constitutes a public offering of securities (whether bonds or equities); (2) the prohibition of underwriter "takedowns" in best efforts underwritings; (3) examples of other unethical practices that undercut the principle of a *bona fide* public offering; and (3) mitigating measures or outright prohibitions of other courses of conduct by underwriters and issuers that may give rise to a conflict of interest vis-à-vis the investing public.

C. NASD/EFS Team Recommendations

(1) Promoting Growth of the Product

- Mobilize the non-bank underwriting community to produce a study that makes the economic case for issuers to select bond offerings over direct borrowing; this study would be used to educate issuers on the merits of capital raising via public offerings of debt (Responsible Parties: ECMA and CASE with a presentation of the study to CMA.)

- Based on the preceding step, launch an issuer education campaign; (Responsible Parties: Non-bank underwriters in cooperation with ECMA and CASE.)

- Review and streamline CMA rules/procedures for issuers seeking to make public offerings of bonds; evaluate the feasibility of providing a "fast track" procedure for established issuers with a strong record of compliance with the financial disclosure regime; (Responsible Parties: CMA with a report and action plan to its Board.)

- Examine the licensed bond rating agency focusing on its cost drivers and business plan with the objectives of lowering costs and expediting the delivery of ratings to potential bond issuers; if needed, amend rules governing the operation of a rating agency; (Responsible Parties: CMA

with a report to its Board and recommended action plan and timetable to the rating agency; if a rule change is needed, it should be proposed for comment by the general public before adoption).

(2) Increasing Liquidity by Launching Market Making

- ECMA or CASE to form an advisory committee comprised of CMA-licensed brokers interested in becoming market makers in corporate bonds on CASE; the committee's task would be to develop a feasible set of market making rules and business processes ahead of CASE's inauguration of the new hybrid trading system; (Responsible Parties: ECMA and CASE, with an action plan and report on recommended market making rules to CMA).

- Amend Article 90 of the CML-Executive Regulations to create an exemption for brokers to buy and sell corporate bonds, but only if they commit to make markets in the securities that they hold for their proprietary account; simultaneously, review and amend Chapter 7 of the CML Executive Regulations to grant licenses to brokers that qualify and commit to be bond market makers; Chapter 7, as amended, should complement the proposed market maker regime developed by the advisory committee; (Responsible Parties: CMA, ECMA and CASE, with opportunity for comment by the general public before final decision.)

(3) Increasing the Float Available for Secondary Market Trading

- In collaboration with CBE, develop a strategy to require banks with holdings of at least 10% in a particular corporate bond to act as a market maker in the issue on CASE; this market making commitment should be fulfilled through a member of CASE, whether affiliated with the bank or an independent broker contracted by the bank to make markets on its behalf. (Responsible Parties: CBE and CMA, with an action plan and timetable to their respective decision-making bodies.)

(4) Halting the Artifice of Using Nominees to Qualify Bonds for Listing on CASE

- CMA to remind CASE of its legal authority to reject listing applications made in "bad faith" and to refer such matters to CMA for possible enforcement action; (Responsible Parties: CMA and CASE.) Develop a code of corporate finance regulations that would clearly define, among other things: (1) what constitutes a public offering of securities (whether of bonds or equities), (2) the prohibitions of underwriter "takedowns" in best efforts underwritings and other unethical practices that tend to undercut the principle of a *bona fide* public offering; and (3) mitigation measures or outright prohibitions of courses of conduct in conjunction with underwritings that may gives rise to a conflict of interest vis-à-vis the investing public or otherwise disadvantage investors. (Responsible Party: ECMA and CMA with solicitation of comments from the general public.)

2. Government Bonds

A. General Description of Existing Environment

The government securities market in Egypt consists of two product segments, treasury bills with maturities up to one year, and treasury bonds with maturities ranging from 3 to 20 years (hereinafter referred to as "government bonds" or "GOE bonds"). The latter segment was the focus of the NASD/EFS Team's review because the treasury bills segment is considered to be quite efficient, both in terms of market participation and market liquidity. Therefore, the comments below refer exclusively to the issuance and trading of GOE bonds with maturities greater than one year.

The primary market for GOE bonds relies on periodic auctions via the Primary Dealer System (PDS) to place new issues. As of year end 2005, a total 11 issues of government bonds had been placed via the PDS, 8 during 2005 and 3 in 2004. The turnover in these 11 issues amounted to LE 8.5 billion in 2005.

The universe of PDs who support the PDS consists of 14 banks that have been approved by the MOF and CBE. PDs submit bids directly to the CBE for inclusion in the periodic auctions. (The bids may be sent on paper or in electronic form.) The bids placed by a PD reflect its proprietary trading interest as well as the trading interest of other intermediaries (e.g., non-PD banks, insurance companies, and brokers acting as agents for individual clients) and the trading interest of a PD's own clients. The auction price determined by the PDS for an issue of government bonds is given to all persons whose buying interest was reflected in the winning bid(s). A PD is not permitted to charge a mark-up or commission to the end purchasers of the bonds because it is compensated by the MOF for its underwriting the offering.

All GOE bonds are tax-exempt, and listed on the CASE although no listing fee is paid for this service. The listing is not a condition for the tax exemption, but apparently is done with a view to fostering transparency of price information to facilitate secondary market trades. At present, there is no real-time dissemination of the prices of secondary market trades in GOE bonds and no central site that captures and displays the firm quotes of all PDs who are willing to act as dealers for secondary market trades.

In both the primary and secondary markets for GOE bonds, PDs are the focal point of the market processes for price formation, trade reporting, and clearance and settlement. Brokers are basically shut out of these processes by the regulatory framework. Although Chapter 7 of the CML Executive Regulations envisioned the CMA's licensing of securities intermediation companies--i.e., brokers--as bond dealers, only two firms ever obtained such a license. Apparently, neither of these dealers chose to apply for MOF approval as a PD, presumably due to the underwriting requirements in primary auctions. Today, the only privilege enjoyed by the two Chapter 7 licensees is their ability to acquire and hold government bonds (or corporate bonds) in a proprietary account. All other CMA-licensed brokers are precluded from having proprietary positions in any security, including government bonds, pursuant to Article 90 of the CML Executive Regulations.

Separately, it should be noted that all 14 PDs also hold licenses as bond dealers granted by the CMA. The NASD/EFS Team questioned members of the

CMA and CBE staffs about the necessity for this license and an explanation of the CMA's role in monitoring the activities of PDs based on the jurisdiction conferred by the CMA license. No interviewee could describe any regulatory or oversight function performed by the CMA based on its having issued a license to the 14 banks that are PDs.

The legal framework governing operations of both the primary and secondary markets for GOE bonds mainly consists of two MOF decrees issued in 2002: (1) MOF Decree No 480 for 2002 Establishing the Primary Dealer System (the "PD Decree") and (2) MOF Decree No. 723 for 2002, Executive Regulations for Decree No. 480 for 2002 (the "PD-Executive Regulations").

Both decrees envisioned PDs as liquidity providers in the secondary market. Article III.H of the PD-Executive Regulations defined the role of PDs as market makers to provide liquidity for the secondary bond market. Article VII details the content of additional regulations that would be needed to implement the market-making regime (e.g., methods for disseminating quotation prices, maximum spread parameters, and standard quotation amount). Further, Article VII specified that a Primary Dealers Association (PDA) would be established by PDs to draft the specialized rules for market making and secondary trading in general, subject to the MOF's approval before implementation.

At the time of this report, the NASD/EFS Team confirmed that the PDA exists and that it is still working with the PD community to finalize a convention that would fulfill the requirements specified in the PD-Executive Regulations issued in 2002. In this regard, the PDA also is working with Reuters to finalize the content/specifications of an electronic page that would be the vehicle for collecting and disseminating the PDs' firm quotes as market makers.

Even without the PDA's final rules package, several interviewees stated that some PDs are willing to quote firm prices if called upon by another PD or even one of their clients. After the terms of a trade are negotiated outside the CASE system, the sell-side party must report the trade to a separate system operated by CASE strictly for PD reporting, and it is confirmed by the contra side. If a PD is selling bonds to (or buying bonds from) a client rather than another PD, the affected PD both reports and confirms the trade through the CASE system. CASE batches the confirmed trades and transmits them to MCDR for clearance and settlement.

The foregoing process assumes no role for a CMA-licensed broker to bring his client's order, as agent, to a PD for execution and clearance through the secondary market facilities. Only PDs are allowed access to CASE's trade reporting and confirmation system for secondary market trades in government bonds. Thus, if a broker wanted to execute a client's order to buy or sell government bonds as agent, the broker would have to disclose the client's identity to the PD; the PD would have to confirm the trade with the client (e.g., by telefax); and the PD would both report and confirm the trade through the CASE system. This cumbersome process has the effect of driving the clients to deal directly with the PDs.

Another major initiative pending for some time is the formulation of a standard agreement for repurchase transactions (REPOs). This agreement (a security in itself) could be used for secondary market transactions between PDs, or between them and their customers. Representatives from the PD community and the MOF-US Treasury Advisor assisting this development both emphasized that finalization of the standard REPO agreement was absolutely essential to create a liquid secondary market in government bonds. In addition, the adviser observed that short selling to

support secondary market liquidity would be facilitated by reverse-REPOs that enable the short seller to meet his delivery obligation at settlement. Approval of the draft standard REPO agreement by CMA, MOF, or CBE, whichever has primary responsibility, remains to be done. The Team was unable to determine why these three organizations have not yet collaborated to complete this task.

On the other hand, the NASD/EFS Team found that regulatory responsibility for oversight and regulation of secondary market trading in government bonds is split among several parties. Under the 2002 decrees implementing the PDS, the MOF is clearly responsible for overseeing the PDs' participation in the System, monitoring their bids, and reviewing various reports that they must file under Article IV of the PD-Executive Regulations. Based on the Team's interviews with the affected government regulators (MOF, CBE, and CMA), it appears that none inspects PDs to verify compliance with a series of operational requirements set forth in the PD-Executive Regulations such as: (1) Article IV.B (Technical Requirements), Article V.A (Organization) and .B (Systems and Procedures), Article VIII (Customer Requirements), and Article IX (Restrictions on Activities).

As for the PDA, one interviewee suggested that it should be authorized as the industry SRO, which would entail enforcing the proposed market making conventions for PDs and verifying compliance with operational requirements via inspections. At this time, the PDA does not have SRO status or resources to carry out a specialized program of regulatory inspections. The Team was advised that the organization will rely on "moral suasion" to enforce the proposed market making requirements for PDs. In any case, the PDA does not presently have the capacity to be an SRO.

Lastly, the NASD/EFS Team confirmed no government regulator with a stake in the orderly operation of the nation's bond market (i.e., CBE, MOF, and CMA) or CASE is performing routine surveillance of the secondary market activities in government bonds to detect possible trading abuses.

B. Identification and Analysis of Impediments to Product Growth and Market Efficiency

(1) Mitigating the Bias Toward Banks

In Egypt, the universe of PDs consists entirely of banks, and this type of dominance is not un-common in many countries. Indeed the banks' dominance would likely remain even if the two brokers licensed as Chapter 7 bond dealers were to become authorized as PDs. Based on its review of background documents and interviews with industry professionals, the NASD/EFS Team surfaced no particular concern about the PDS or the manner in which the PDs function pursuant to the MOF decrees governing the PDS. Instead, the major policy concerns that were raised related to the diminished opportunities for brokers in terms of secondary market transactions in government bonds along with the lack of liquidity being provided by PDs, notwithstanding a mandate for market making that dates back to 2002.

During the course of the Team's interviews with brokers, several mentioned that prior to the PD Decree, they had generated a fair amount of commission business from executing, as agent, clients' orders for government bonds. As described above, access to the CASE system for reporting and confirming secondary market trades in government bonds has been strictly limited to PDs since the advent

of the PD decrees in 2002. The structure of this process effectively precludes a broker from attempting to earn a commission by negotiating a good execution for a client seeking to buy or sell government bonds. Under the new CASE membership rules, issued in April 2006, trading in government bonds is still restricted to bank PDs without any financial and operational requirements. In contrast, bond dealers licensed under Chapter 7 of the CML Executive Regulations are subject to financial requirements (paid up capital of LE 10 million, net capital of LE 750 thousand, or 15% of total liabilities whichever is greater, and insurance of 0.001% of turnover) as well as operational requirements.

Although a PD may earn a profit on its dealer spread, that spread may be geared to large institutional purchasers (or sellers) rather than the small retail customer often serviced by the brokers. Whether such customers would benefit from the intermediation of a broker is something that should be left to market forces rather than being discouraged by the market structure and access rules. Therefore, the NASD/EFS Team believes that CASE's trade reporting, and MCDR's clearance and settlement requirements for secondary market trades in government bonds should be reviewed and modified, as needed, to allow an even opportunity for brokers to compete for retail business in government bonds. A collateral benefit from this change may be a greater willingness among brokers to advise their clients—particularly inexperienced clients—to invest in bonds as opposed to pursuing speculative strategies such as day trading. If this attracts additional order flow to the secondary market for government bonds, it will also be a positive development for the PDs as market makers.

Since Egyptian brokers are typically members of CASE and direct participants in the MCDR, they should collaborate with their regulator on ways to open business opportunities to the broadest possible universe of qualified brokers, regardless of whether they are independents or bank affiliates. The objective should be to stimulate competition for order flow and innovation while maintaining an appropriate level playing field of regulation by function, as opposed to regulation by institution.

The NASD/EFS Team understands that CASE is proceeding to build an upgraded trading system that would enhance secondary trading of bonds as well as equities. Among other things, we understand that the new system will support a hybrid market model allowing for market making and direct entry of orders into a public order book. This initiative may provide an ideal opportunity for CMA, CASE, and MCDR to update the regulatory framework so as to remove unjustified barriers to competition among different classes of financial intermediaries. Given that CASE effectively provides the only national securities market in Egypt, it is important that this market seek to accommodate the widest potential universe of intermediaries, consistent with the protection of investors and the achievement of functional regulation.

Another step toward leveling the playing field between licensed brokers and banks would be to Amend Article 90 under the CML Executive Regulations to allow brokers to hold proprietary positions in government securities. If done, this would bolster the brokers' balance sheets and not pose any threat to investors.

Amendming of article (90) should be done in tandem with revision a of chapter (7) of the CML Executive Regulations on "Bond Dealers".

(2) Promoting Secondary Market Liquidity Through Market Making

The role of PDs, as market makers, is recognized as a key development in building secondary market liquidity in government bonds. The PDA has proceeded to develop a series of rules that would define the minimum obligations of market makers consistent with business practices and conventions in Egypt. Final approval of these requirements by the MOF (perhaps with concurrence from the CMA) should be a high priority to stimulate liquidity. Such approval should also accelerate the PDA's efforts to display PDs' quotes in real-time via Reuters and potentially other vendors.

Approval of the proposed REPO agreement should also proceed in tandem with the effort to launch a market making regime for the secondary market in government bonds as soon as possible. Additionally, the concept of regulated short selling by PDs should also be introduced to enable market makers to quote two-sided markets continuously during market hours.

Another option to be considered is to encourage the existing Chapter 7 licensed bond dealers to function as market makers in government bonds. This possibility should be actively considered when the Reuters page for PDs' quotes is fully operational or when the upgraded CASE trading system is in place, whichever occurs first.

Lack of price transparency also constitutes an obstacle to creating more liquidity in the secondary market for GOE bonds. How quickly this will be resolved by the PDA and the MOF (by approving the final market making rules) remains to be seen. Meanwhile, it is suggested that the CMA review the CASE plans for upgrading its trading system to ensure that adequate price transparency will be accorded to PD-market makers' quotes and trade reports when the new system is launched.

(3) Delivery versus Payment in the settlement system

The benefits of developing a liquid bond market go beyond government finance at lower costs: one is a liquid government bond market that facilitates pricing of other and riskier financial assets (securitization bond for example).

The different properties of bonds and equities, the trading environment, and customer characteristics affect the way participant's trade, and as such impact their liquidity. To preserve investor confidence, assure market liquidity, and reduce settlement risks, the settlement system for debt securities must demonstrate a higher performance standard than for equities. The future functioning of a bond market modeled after the equity market framework requires adjustment. Another issue in bond trading is the adverse effect of transaction and settlement costs that encourage banks to avoid the central clearing and settlement system, or avoid trading in bonds in general.

EFS has proposed to the CMA that this could be achieved by adopting a settlement system of "same or next-day" clearing of funds and securities, based on gross principles ("Basel Delivery versus Payment model 1" of "gross" (i.e., no netting) transfer of securities and "gross" transfer of money.

Improving the settlement system and reducing risks should broaden the investor base by attracting institutional and foreign investors to the government bond market and possibly the corporate bond market, and consequently improve liquidity and encourage institutional investors to give-up a "buy-and-hold" strategy. Accordingly, improved and changed market preferences could help broaden the

range of debt instruments, thus deepening the secondary market and offer participants diversified risk prices.

In that respect, the MCDR and CMA should continue exploring with the CBE the means to implement true Delivery versus Payment to the greatest possible extent, and seamlessly connect the payment system operated by the CBE to the MCDR securities settlement systems for immediate settlement of securities transactions, if possible in real time, to achieve the objective of enhancing the settlement system for fixed-income securities.

(4) Better Coordination among Regulators

As noted above, there is no comprehensive plan for inspection of PDs as liquidity providers, or for the surveillance of trading in the secondary market for government bonds. Although the MOF probably has the most active regulatory role, it appears limited to enforcing rules governing the auction process and monitoring the PDs' participation in that process. The MOF, CBE, and CMA have no routine inspection cycle by which they test the PDs' compliance with operational requirements related to their PD business.

Given the prospects for increased liquidity and broader retail participation in the secondary market for government bonds, it is important for the CMA, MOF, and CBE to decide on an appropriate allocation of inspection and market surveillance responsibilities. This might be done through the establishment of a Regulatory Working Group that meets every other month to discuss regulatory policy issues, and to identify and resolve matters of jurisdictional overlap. The output of this Group should be a MOU that sets forth an acceptable inspection regime; allocates responsibility and resources for carrying out that regime; provides for a sharing of inspection results among the working group's three sponsoring organizations; and establishes a process for annual reviews of the inspections manual to reflect changes in the way that the bond market operates.

With regard to trading surveillance, it appears that CASE is in the best position to assume this responsibility in the near term. This conclusion is based on the fact that CASE already receives the details of all confirmed trades and presumably has the capacity to construct an audit trail from this data for each traded instrument. This transactional data would constitute the "raw material" on which to build a system to conduct surveillance for fraudulent or manipulative trading practices. PDs are now members of CASE pursuant to the recently adopted membership rules. As such, CASE should have an ample legal basis to suspend access or otherwise sanction any participant who violates a contractual requirement or applicable rule.

To the extent that CASE's new trading system will provide a platform for the capture of market makers' quotes in government bonds, CASE would be the logical candidate for monitoring the PD-market makers' behavior for compliance with the trading obligations established by the PDA trading rules.

To pursue the above strategy, it is advisable for CMA to consider modifying article (94) of the CML Executive Regulation to specify the scope of CASE's responsibilities for monitoring and investigating secondary market activities in government bonds. Under this modification, CASE should be required to produce an appropriate procedures manual that conforms to the scope of surveillance work reflected in the modification. Thereafter, the CMA must be prepared to inspect the CASE's surveillance activities to verify that they conform to the requirements

specified in the modified article (94). If CASE would prefer to outsource this surveillance activity, the CMA should be prepared to scrutinize the output of that contractor for conformance with the modified article.

C. NASD/EFS Team Recommendations

(1) Mitigating the Bias Toward Banks

- Review the pertinent rules, processes, and rationales for restricting access to the CASE system for reporting and confirming secondary market trades in government bonds to PDs; the objective is to identify and remove barriers that render it unfeasible for brokers to execute client orders as agent against the dealer interest displayed by PDs as market makers; (Responsible Parties: CASE and MCDR with a report to CMA.)

- In conjunction with the upgrade of the CASE trading system and implementation of the Reuters page for bond dealers' quotes, review the corresponding rules to ensure that they achieve functional regulation and do not pose unjustified barriers to different classes of members that compete for the same order flows, by product category; the objective is to open up business opportunities to the widest possible universe of licensed intermediaries that are members of CASE; (Responsible Parties: CASE and MCDR with a report to CMA.) and

- Amend Article 90 of the CML Executive Regulations to allow brokers to hold proprietary positions in government securities and revise chapter (7) of the CML Executive Regulation "Bond Dealers accordingly"; (Responsible Party: CMA with input from ECMA and the general public.)

(2) Promoting Secondary Market Activity Through Market Making

- Finalize and approve the PDA standards for market making and introduction of short selling by a date certain in 2006; (Responsible Parties: PDA, MOF, CBE and CMA)

- Complete regulatory review and approve the draft standard REPO agreement for PDs and their customers by a date certain in 2006; (Responsible Parties: MOF, CBE, and CMA.)
- Consider ways to encourage the existing (non-bank) licensed bond dealers to provide liquidity as market makers in the secondary market in government bonds, in light of the installation of the Reuters page for PDs' quotes, the upgraded trading system at CASE, and proposed updates to Chapter 7 of the CML Executive Regulations to license intermediaries as market makers in government debt securities (as well as corporate debt) (Responsible Parties: ECMA, CASE, PDA and CMA.)

- Improve existing price transparency by electronic collection and dissemination of PDs' quotes for potential secondary market trades in government bonds via the Reuters page, by a date certain in 2006; (Responsible Parties: PDA, MOF, and CMA.) and

- Review design of upgraded CASE trading system to ensure adequate means for real-time dissemination of all market makers' quotes and

transaction reports related to the secondary market trades in government bonds; (Responsible Parties: PDA and CASE with report to CMA.)

(3) Delivery versus Payment in the Settlement System

- Enhance the payment system to meet the high performance standards of Delivery versus Payment of fixed-income securities settlement; (Responsible Parties: CMA, MCDR, and CBE.)

(4) Better Coordination among Regulators

- Establishment of a Regulatory Working Group that meets regularly to discuss regulatory policy issues, and to identify and resolve matters of jurisdictional overlap with regard to regulation of the secondary market in government bonds; (Responsible Parties: CMA, MOF, and CBE)

- The Group should determine an appropriate allocation of inspection and market surveillance responsibilities, which allocation shall be memorialized in a MOU; (Responsible Parties: CMA, MOF, and CBE)

- Specify CASE responsibility to perform trading surveillance for the secondary market in government bonds and modify article (94) of the CML Executive Regulations to spell out the scope of its responsibilities; (Responsible Parties: CMA and CASE, with a report to the Regulatory Working Group); and

- Conduct annual inspections to ensure adequate market surveillance is performed; (Responsible Parties: CMA with report to the Regulatory Working Group)

- Take steps to achieve Delivery versus Payment in fixed-income securities settlement (Responsible parties: CMA, MCDR, and CBE with a report to the Regulatory Working Group).

3. Investment Funds

A. General Description of Existing Environment

There are 36 investment funds at the present time. Twenty-nine are open end, 4 are closed end and 3 are direct investment funds. Only one of the closed end funds is listed on the CASE. The three direct investment funds invest in private companies are sold through a private placement to individuals who qualify as "financially solvent", according to the criteria set forth in the CMA Private Placement Manual. While there is no uniform classification for funds, the Team understands that of the open end funds, 11 invest solely in listed equities, 5 invest solely in fixed income instruments, 5 invest in both equities and fixed income, and the remaining 8 funds are not easily classified by investment mix. In addition to these 36 funds that are licensed and regulated by the CMA, the CASE 2005 Yearbook lists 8 offshore funds that invest in CASE listed securities. Dividends and capital gains of investment funds are exempted from income tax under the Income Tax Law of 2005.

According to the CMA, the 36 funds were valued at LE 7.1 billion at their inception. At the end of 2005, they had a value of LE 18.4 billion, a 159% increase.

At the end of 2005, market capitalization of stocks amounted to LE 456 billion and value of bonds outstanding was LE 52 billion. Thus, the total value of both stocks and bonds was LE 508 billion. Assuming, conservatively, that all investment funds are fully invested in stocks and bonds, investment funds would represent only 3.6% of the total, which illustrates the small size of the investment fund market at the end of 2005.

Open end funds are bought, registered and sold through a sponsoring bank or insurance company. Based on available information, 15 banks and one insurance company sponsored the 29 open end funds which are managed by 11 licensed investment managers.

Insurance companies and private prevision funds are limited by law and regulation as to how much of their holdings can be invested in securities. At a minimum, they must invest 25% of their funds in government securities but are limited to a maximum of 15% in tradable bonds and 25% in tradable stocks. According to the Egyptian Insurance Supervisory Authority, at year end 2005, investments by insurance companies in corporate bonds, stocks and investment funds were LE 5 billion or 30.2% of their total investments. By way of comparison, their investments in government instruments, including government bonds and treasury bills, equaled 29.3% of their portfolios for a total of LE 4.9 billion. The largest percentage of total investments was in bank deposits, equaling 35.5%. These statistics suggest that while insurance companies need long-term investments to match their long term liabilities (e.g. life insurance), their present investment strategy reflects a bias towards the short term, which suggests the capital market does not offer enough long term investment vehicles. If not changed, this will have a negative impact on future development of the Egyptian capital market.

Separately, paper certificates carrying two signatures evidence ownership in a fund. The certificate must be surrendered by the owner in order to sell or redeem shares. While brokers are not precluded from buying and selling open end investment funds as agent for their customers, they rarely do so because for it is easier for the customer to deal directly with the fund sponsor.

Net asset value (NAV) is calculated by open end funds as required by CMA Directive. It is released on a weekly basis through the newspaper and, in some cases, via a telephone number dedicated for this purpose and advertised by the fund. The current system for pricing transactions in open end funds is on a “backward pricing system”. NAV of closed end and direct funds is generally not calculated or released (except for two funds listed on CASE).

Investment funds are authorized and regulated under the Capital Market Law (CML) No. 95 of 1992, Section Two, Articles 35 through 41. The corresponding CML Executive Regulations, Chapter Three, Section Two (Articles 140 through 183) govern the licensing of closed end investment funds, the registration of the investment manager, and the licensing of banks and insurance companies to sponsor open end investment funds.

Three aspects of the current CML and CML Executive Regulations are particularly important to note. First, only banks and insurance companies are allowed under the law to sponsor open-end investment funds. Second, when the CML Executive Regulations were adopted in 1992, it was anticipated that closed end funds would be the most popular form of mutual fund. Twenty-two of the 43 provisions in the CML Executive Regulations are intended to apply to closed end funds, although certain provisions apparently apply to both types of funds. Few

closed end funds have been offered since 1992. Third, the CML Executive Regulations affecting investment funds have been amended several times since 1992 by Ministerial Decree, by CMA Board of Directors' Decrees and by CMA directives. These amendments are not codified or readily available to market participants or the public, thus causing significant confusion.

The initial licensing and registration functions for investment funds and investment managers are carried out by the CMA. The CML Executive Regulations also set forth ongoing requirements for diversification of investment, liquidity, handling of redemptions, accounting and other matters pertaining to the fund. CMA reviews periodic reports filed by investment funds and plans to establish regular oversight exams to further measure funds' compliance with the continuing requirements.

The Egyptian Investment Management Association (EIMA), in cooperation with the USAID Capital Markets Development project, developed standards for the calculation and presentation of funds' investment performance in a fair, comparable format that embodies the requirements of Global Investment Performance Standards (GIPS) adopted in 1999 by the Association for Investment Management and Research. EIMA has made these standards mandatory for its members. Other investment managers apparently follow these standards even though they are not required to do so. EIMA also took the initiative to develop a course for asset managers which covers finance, constructing a portfolio, and portfolio evaluation. This course was launched in 2001 and to date has trained 95 individuals. EIMA's goal is to have this course become a mandatory qualification for a CMA license as an investment manager.

B. Identification and Analysis of Impediments to Product Growth and Market Efficiency

(1) Growth of Institutional Holdings

Both the CMA and market participants want the investment fund market to grow. Professionals interviewed by the NASD/EFS Team believe that increasing the institutional participation in investment funds is one of the keys to such growth. Today the market is 70% retail, 30% institutional. If there were a greater institutional presence, many believe the current speculative fever in the market would be significantly dampened.

As noted earlier, investments in corporate bonds, equities and investment funds by insurance companies constitute only 30% of their total investments. Since insurance companies are only one of the many institutions that have long term funds to invest, there is significant upside potential in terms of institutional investment via investment funds. Specifically, investments are also held and managed by the National Post Office, the National Investment Bank, and the army and police pension funds, just to name just a few. Mobilizing these and other available institutional money into Treasury bonds, corporate bonds, and investment funds should be encouraged through education of officials responsible for the investment policies at these institutions. Both the government and market participants also should participate in this effort. The focus of the education should be on the long term needs of these institutions and how bonds and fixed income investment funds provide safe, liquid investments that fulfill the institutions' fiduciary responsibility to grow their stakeholders' funds. Where appropriate regulations that restrict the

percentage of total investments such institutions can place in risk-free government bonds and diversified investment funds should be repealed.

(2) Diversify Sponsorship

Only banks and insurance companies are authorized by the CML Executive Regulations to sponsor and distribute open end investment funds in Egypt. In fact, only one insurance company has sponsored even one fund. Thus, in reality, only banks are sponsors of investment funds. Because banks may view investment funds as competing with their core product line – deposits and savings accounts – it is unwise to rely upon them exclusively for the further development of the mutual fund market.

The number of investment funds would grow significantly if both investment managers and brokers were allowed to be sponsors. The Team's interviews found support for allowing investment managers to be sponsors. Any concerns that might arise with regard to conflicts of interest between a company's responsibilities as both a sponsor and an investment manager could be addressed through regulation and oversight inspections. In fact, Commercial International Bank (CIB) and its subsidiary CI Asset Management is a pertinent example of how a company can act as both a sponsor and an investment manager. While CI Asset Management is considered "independent" in compliance with the current CML Executive Regulations, in practice it is 40% owned by CIB and the CIB Board plays a part in setting the investment policies of the funds managed by the subsidiary. There is no reason to believe that the CIB example is not an effective model. Experience in other countries has shown that investment managers are some of the most capable sponsors of investment funds. Therefore, CMA should amend the CML Executive Regulations to authorize licensed investment managers to sponsor investment funds.

There was less support among those interviewed for allowing brokers to sponsor investment funds. However, the Team believes that brokers should be allowed to sponsor investment funds within a proper regulatory framework. This would include, for example, appropriate capital requirements and a separation of responsibilities between investment management, distribution of the fund, and custody of investments and money of the fund. It is equally important that CMA put in place a vigorous oversight program to ensure broker compliance with such requirements. A senior CMA official pointed out that there is the natural fear that a broker might establish a "Ponzi scheme" if allowed to sponsor investment funds. However, this fear can be addressed effectively through regulation – particularly the CMA review of the prospectus – and effective oversight inspections. There is no reason to believe that under circumstances controlled by effective regulation that well-capitalized brokers should not be allowed to sponsor investment funds.

Allowing brokers to sponsor funds could provide the single most effective means of growing the mutual fund industry. Brokers have the requisite customer base – both retail and institutional – and no competing products, like banks have, to deter them from fulfilling the role. Like any investment product, investment funds must be actively sold. Brokers have both interest and the ability to sell investment funds and thereby grow the industry. CMA should give serious consideration to how the CML Executive Regulations could be amended to authorize brokers to act as sponsors of funds.

While brokers are not precluded from selling investment funds, for the most part they do not. There are two reasons why. First, in most cases brokers are not compensated by either the bank sponsor or the investment manager for selling the

fund. In fact, the Team was told that brokers sell offshore funds to their clients because such funds do compensate them. Secondly, because the broker's customer must deal with the bank sponsor to either buy or redeem shares, there is little advantage to the customer to use his broker for the transaction. Unless banks are seriously interested in expanding their distribution networks for securities products, it is difficult to identify an economic incentive for banks to use brokers to distribute their funds.

(3) Clarify and Update the CML Executive Regulations

The laws, decrees and CML Executive Regulations that govern investment funds are confusing and not readily accessible to market participants or the investing public. The Team found differences of opinion among interviewees as to the application of various provisions. For example, there is confusion over whether brokers can sell investment funds to their clients in the first instance. While the CML Executive Regulations clearly do not prohibit funds from investing in foreign securities, market participants believe that CMA prohibits it. The CML Executive Regulations contain separate chapters pertaining to closed end and open end funds. However many of the provisions pertaining to closed end funds also apply to open-end funds. In order to address this deficiency, the CML Executive Regulations on open end funds include the following catch-all Regulation: "Subject to any special provision prescribed in this Subsection, the provisions and procedures governing the Investment Fund Companies stipulated in the Law and these CML Executive Regulations shall apply to the Investment Funds established by Banks and Insurance Companies." This language creates uncertainty for sponsors of open end funds and could result in non-compliance with important provisions. The CML Executive Regulations pertaining to open end funds should be expanded and clarified by CMA.

Article 175 of the CML Executive Regulations requires the fund sponsor to maintain a 5% investment in the fund. If the fund grows from its initial value, the sponsor must maintain a 1:20 ratio in terms of its investment in the fund. Under the present market conditions, the fund could grow exponentially which would require the sponsor to invest significant additional resources. While the initial required investment of LE 5 million is reasonable and demonstrates the sponsor's commitment to the fund, the requirement to grow the investment as the fund grows does not appear to serve any regulatory purpose, and it puts the sponsor in the position of competing for investment returns with public investors. Furthermore, it could act as a barrier to entry and a clear disincentive to sponsoring a mutual fund. This requirement should be removed from the CML Executive Regulations.

Finally, the requirement of paper certificates to signify ownership in an open end fund adds administrative expense and unnecessary delay to the buying and selling of such funds. As noted above, it is also one of the impediments to brokers selling investment funds, thereby reaching a broader base of investors. Dematerialization of all funds at the MCDR would streamline the industry and prepare for expansion in the number of investment funds and fund holders.

(4) Standardize Fund Classifications

There is no standardized classification for funds as to their type, e.g., growth, fixed income, etc. As a result, each list of funds that the Team was given classified the same funds differently. Symptomatic of this same problem, during the Team's interviews with market participants, the term "money market fund" was used in several different contexts. In some cases the term was used to refer to a fund that invests strictly in fixed income securities and in other cases it meant an account at a

bank where the customer gets 1 to 1½ percent above a benchmark rate. The lack of consistent terminology confuses investors. The EIMA is well suited to take responsibility for developing a uniform system for classifying funds by type.

In addition to the lack of standard classifications, funds are generally named after the bank that sponsors them. This results in multiple funds being distinguished one from another simply being noted by the sequence in which they were offered. For example, two funds sponsored by National Bank of Egypt are called the National Bank of Egypt and National Bank of Egypt II. Differentiation of one fund from another both through a standard classification system and a naming convention would greatly help investors to understand and differentiate the respective funds. The development of a standard naming convention could be carried out by EIMA.

(5) Amend Pricing System for NAV and Adopt GIPS Standards

The current system for pricing transactions using the NAV calculation is under a “backward pricing system”. This type of system is considered risky to investors as it can cause a serious influx of redemptions during a market crisis and exacerbate the market decline. Most other markets around the world use a “forward pricing system”, whereby all transactions which occur subsequent to the last price calculated are priced at the next price calculated. As more and more funds move to daily calculation of NAV in Egypt, this issue of forward versus backward pricing will disappear.

As noted earlier, the EIMA developed uniform standards for the calculation of the investment performance of investment funds. It would be equally helpful if EIMA were to do the following: (1) develop standards for calculating the total fees and charges of operating a fund, (2) collect the information from each fund; and (3) disseminate a table which sets forth such information so that investors can compare the fees and charges of one fund against another.

(6) Reduce Data Dissemination Costs and Provide Better Data

Investment funds are presently required by the CML Executive Regulations to disseminate their NAV through weekly newspaper advertisements. This is an expensive proposition, the costs of which are ultimately borne by investors in the fund. Since the purpose of newspaper publication is to protect investors, at the very least the cost of publication should be exempt from stamp duty taxes which amount to an additional 36%. CMA should take the lead in seeking tax exemption for the costs of complying with these regulations.

Since these costs are borne by investors in the funds, cost effective alternatives to newspaper publication should be explored as well. Some funds presently advertise a call-in telephone number which investors and the public use to obtain the most current NAV. A table of NAV data and telephone numbers published in the newspaper on a weekly basis, rather than individual ads by each fund, would reduce significantly the space required and the cost to funds as a whole to meet this requirement. It might be appropriate for EIMA to assume the role of assembling and disseminating such a table on a weekly basis, allocating the costs proportionately to the participating funds. The funds in the table could be organized by fund category according to the convention defined by EIMA as discussed earlier.

Looking further into the future, consideration should be given to CASE, through its subsidiary EGID, receiving the NAV data directly from the funds and

disseminating it electronically to all of its media and market data outlets. At the same time, EGID might operate a consolidated "call-in center" where any investor could call a single telephone number to get NAV data on any fund.

Investment funds are also required to publish their semi-annual financial results in the newspaper (and some even do it on a quarterly basis). This publication is even more expensive than the NAV weekly ads. In addition to the expense, which investors in the fund ultimately pay, these reports can be as much as three months old by the time they are published. During the interim, the fund's portfolio could change significantly. Hence, a stale financial report can be materially misleading to investors. By contrast, the fund's weekly dissemination of NAV information is far more useful and timely for investors. For reasons of expense and untimely publication, the semi-annual newspaper publication of financial results should be eliminated.

C. NASD EFS Team Recommendations

(1) Growth of Institutional Holdings

- Educate institutions managing life insurance, pension and other funds about the safety and soundness of investing in fixed income investment funds; (Responsible Parties: Government agencies/Ministries with jurisdiction over such institutions, ECMA, EIMA and CASE with support from CMA)

- Amend regulations as necessary to allow more latitude to institutions to invest in investment funds; (Responsible Parties: Government agencies/Ministries with jurisdiction over such institutions)

- Fund sponsors or fund managers should be encouraged to compensate brokers for selling investment funds to their clients thereby broadening their distribution network; (Responsible parties: ECMA and EIMA to explore the issue with existing sponsors and investment managers and propose solutions).

(2) Diversify Sponsorship

- Add a provision to the CML Executive Regulations to allow both investment managers and brokers to sponsor investment funds; (Responsible Parties: CMA with assistance form EIMA on investment managers and ECMA on brokers, with opportunity for public comment on the proposed amendment.)

(3) Clarify and Update the CML Executive Regulations

- Amend Articles 140 – 183 of the CML Executive Regulations or replace with a new chapter on investment funds to create separate and distinct requirements for closed end and open end investment funds, and incorporate all requirements pertaining to investment funds that had been adopted by Ministerial Decrees, CMA Board of Directors Decrees or CMA Directives since 1992; (Responsible parties: CMA with input from EIMA and an opportunity for public comment.)

- Remove Article 175 from the CML Executive Regulations having to do with the fund sponsor maintaining a 1 to 20 ratio in terms of its investment in the fund compared to the value of the fund; (Responsible parties: CMA with input from EIMA and an opportunity for public comment.)

- Remove all references to paper certificates for mutual fund ownership from the CML Executive Regulations and add new provisions authorizing dematerialized certificates; (Responsible parties: CMA with input from MCDR, and opportunity for public comment.)

(4) Standardize Fund Classifications

- Develop a standard classification system with definitions for investment fund types and establish a standard naming convention for investment funds; (Responsible parties: EIMA and approval by CMA)

(5) Amend Pricing System for NAV and Adopt GIPS Standards

- Amend Article 177 in the CML Executive Regulations to require a forward pricing system for redemptions on funds that use a weekly calculation of NAV; (Responsible parties: CMA with input from EIMA.)

- Add a provision to the CML Executive Regulations that requires investment funds to follow the GIPS standards developed by EIMA; (Responsible parties: CMA with input from EIMA, and opportunity for public comment)

- EIMA to develop standards for calculating the total fees and charges of operating funds, gather the information from each fund, and disseminate a table which enables investors to compare one fund to another; (Responsible parties: EIMA with input from CMA)

(6) Reduce Data Dissemination Costs and Provide Better Data

- Develop and disseminate a table of NAV data and telephone numbers for all investment funds; (Responsible parties: EIMA in the short term; EIMA to explore with CASE and EGID the potential for establishing a central call and data distribution center with an action plan and timetable to CMA.)

- Eliminate the requirement for investment funds to publish semi-annual and quarterly results in the newspaper; (Responsible parties: CMA with input from EIMA.)

B. New Products

There was an overwhelming consensus among the individuals with whom the Team met that the focus of the CMA and the industry should be on improving the market in products that are currently traded – government bonds, corporate bonds, and investment funds – rather than expending substantial efforts on creating new products and adjusting the laws and market infrastructure to accommodate them. Some interviewees expressed moderate interest in exploring and planning for the introduction of new products that would benefit the long term development of the Egyptian capital market. These new products are discussed below.

1. Zero Coupon Corporate Bonds

(a) Description

Zero coupon bonds (also known as “zeros”) do not make any cash interest payments to investors. Rather than the corporation making periodic interest payments, earned interest accrues to the face value of the bond until it matures at par value. The advantage to the investor is that the zero is sold at a deep discount to par because the money the investor will receive at maturity includes both the principal and the interest earned. Although the bondholder forfeits immediate income from the issuer, he also locks in the current interest rate for the life of the bond. It is important for the investor to know that the secondary market price of the zero tends to be volatile, particularly in response to changes in prevailing interest rates. The investor does not have the interest payments to act as a cushion during times of volatility. However, zeros issued at a time when interest rates appear to be at or near a peak are quite attractive. Call features on zeros are based upon the bond’s compound accrued value, which is the price the bond has attained based upon its appreciation from the original issue date at the zero’s yield to maturity rate. As a result, the redemption on a zero can be higher than the yield on a comparable interest-bearing bond.

The advantage to issuing is that zeros are relatively easy to understand for the average investor and thus could be marketed and sold without great difficulty. Because they are sold at a discount, the price per bond may also be attractive to retail investors with a long-term savings objective.

(b) CML Executive Regulations

From the regulator’s point of view, zeros are treated similarly to corporate bonds with one exception. The corporation is required to establish a sinking fund into which the corporation places the accumulating interest payments due to investors at the bond’s maturity. The sinking fund protects investors from the corporation defaulting on its obligation. The CMA will need to amend the CML Executive Regulations to require corporations issuing zeros to provide a certification from their external auditors about the establishment and funding of the sinking fund. In this regard, it may be advisable to add a definition of a zero to distinguish it from other types of corporate bonds.

(c) Capacity Analysis

Since zeros are similar to the corporate bonds that are currently traded with the single exception that they pay no interest, it is reasonable to conclude that intermediaries, the CASE and the MCDR should be able to accommodate zeros into their on-going operations without difficulty. The intermediaries, including brokers and underwriters, should be prepared to educate both corporations and investors on the terms of a zero coupon bond and its advantages and disadvantages as compared to other corporate bonds.

Additionally, auditing firms would have to be able to audit for compliance with the sinking fund requirement by corporations which have issued zeros. The issuance of zeros may or may not have an impact on the rating process or the rating ultimately issued by the rating firm.

The CMA staff would have to be trained on the accounting and regulatory implications of zeros versus straight bonds, and to verify a corporation's compliance with the sinking fund requirement from its financial filings. These changes should be relatively easy to implement.

2. Convertible Corporate Bonds

(a) Description

A convertible bond has an option that allows for the exchange of the bond for the common stock of the issuing corporation at a specified conversion rate. In effect, a convertible bond is a hybrid debt and equity security. While a convertible bond pays interest just like a standard corporate bond, the convertible feature gives the investor the option of capturing capital gains from the rise in the price of the corporation's stock. Additionally, when the equity market declines, a convertible bond's yield provides some protection on the downside.

The advantages are offset by the fact that a convertible bond is normally issued at a lower yield than a comparable nonconvertible corporate bond. Additionally, the conversion rate, or the price at which the investor can convert the bonds into common stock, is fixed and will likely be fixed at a price that is above the stock price at the time of the bond offering. Thus, the convertible feature is worthless unless the stock's price rises above the conversion price. On the other hand, as long as the company can pay its interest and the principal upon maturity, there is a price level to which a bond will fall and fall no further.

The potential for participating in a rise in the corporation's stock price is the main feature that attracts investors to convertible bonds. From the corporation's point of view, the advantage is the lower yield as compared to other non-convertible corporate bonds. At the time the bond is issued, the corporation determines how many shares of stock the bondholder will receive if he exchanges his bond for stock. The exchange is usually made through a custodian who acts as the redemption agent.

The corporation can take two actions which will make it advantageous for the bondholder to convert. Since most convertible bonds are callable, the company can call the bonds at a price lower than their market value, thus prompting the bond holders to convert the bonds to common stock. This is known as "forced conversion". Alternatively, the corporation can increase the dividend on the common stock so that it is to the bondholder's advantage to convert.

(b) CML Executive Regulations

It does not appear that any provisions in the CML Executive Regulations would have to be amended in order to allow convertible corporate bonds to be issued, except perhaps for inserting a definition of this instrument to distinguish it from other categories of corporate bonds.

(c) Capacity Analysis

Like zero coupon bonds, convertible bonds should not pose significant new requirements on the trading system or the clearing and settlement mechanisms already in place. Like zeros, underwriters and brokers would have to familiarize themselves with the features of convertibles so they can explain their advantages to

investors and corporations. In any case, unless underwriters take the lead in educating corporations about zeros and convertibles, it is unlikely that either product will be issued to any great extent by corporations.

It should not be difficult for the CMA staff to incorporate convertibles into the prospectus review process as well as the ongoing review of corporate filings.

3. Exchange Traded Funds (ETF)

(a) Description

An Exchange Traded Fund (ETF) involves a tradable instrument issued by a type of investment company whose investment objective is to achieve the same returns as a particular stock market index. An ETF either invests in all of the securities or a representative sample of the securities included in the subject index. An ETF has some of the advantages of a investment fund while trading like a stock. An ETF provides investors with the ability to diversify their portfolio without having to purchase a multitude of individual stocks.

The CASE-30 Index is the most likely candidate for an ETF. In 2005 ABN-Amro created an offshore product called an Open End Certificate based on the CASE-30 index. The ABN-Amro product is trading on the Swiss Exchange and Frankfurt Stock Exchange. There are other proprietary indices created by Egyptian intermediaries including the Hermes Financial Index, the Egyptian Financial Group Index, the Prime Initial Public Offering Index and the Commercial International Brokerage Company Index which might also be bases for ETFs.

The level of interest in ETFs elsewhere in the world and the creation of an ETF-like product based on the CASE-30 index offshore, suggests that ETFs will trade actively in Egypt once introduced.

(b) CML Executive Regulations

Since ETFs are significantly different from the open end investment funds presently authorized by the CML Executive Regulations, it is strongly recommended that a separate chapter of the Executive Regulations be added to ETF products. Because there are multiple structures allowed for holding the securities of the underlying index, the CMA must be certain that its regulatory framework can accommodate more than one structure. This will require close consultation with the sponsors of the first ETF product that will be introduced in Egypt. Analysis of the ETF frameworks commonly used in North America and Western Europe will also be instructive in defining the range of possibilities that might have to be accommodated in the relevant chapter of the CMA Executive Regulations.

(c) Capacity Analysis

The team was informed by some CMA officials that commercial paper need to be for than 15 month maturity to be regulated by the CMA, otherwise it will be under CBE regulations none of the officials, however, was able to specify which CBE regulation define this criteria. Even so, when the team met with the CBE sub-governor, he informed the team that he is not aware of such regulations and confirmed that CBE is not regulating companies issuing any type of securities. The CMA will need to clarify such confusion with the CBE.

ETFs will be a completely new kind of investment product in Egypt – not a stock and not an investment fund. It will require much more time and effort, as compared to the other new products noted above, to prepare intermediaries, CASE, MCDR, and the CMA for their introduction.

ETFs may not be widely understood. All segments of the industry will need to be educated on the nature of ETFs, how they are traded, cleared and settled, and how they will be regulated. In addition to changes to the CML Executive Regulations and their impact on intermediaries, changes may have to be made to MCDR systems and procedures to handle the clearing and settlement. CMA staff in Corporate Finance, Market Surveillance, and Inspections will be called upon to expand their expertise to regulate this product properly.

Finally the investing public will need to be educated on ETFs and how they can use them to diversify their investments. They also need to appreciate the differences between ETF products and other investment alternatives.

4. Commercial Paper

(d) Description

Commercial paper is a short-term promissory note issued in large denominations (in the U.S. over $100,000 and typically in multiples of $1 million) not secured by collateral. Only the largest corporations have the credit-worthiness to issue commercial paper. Commercial paper provides corporations with a fast, low-cost alternative to bank loans. Most commercial paper has a maturity of 30 – 35 days in the U.S.

(e) CML Executive Regulations

In the U.S., commercial paper is exempt from registration as a security if it is used to finance current transactions and its maturity does not exceed 270 days. Like corporate bonds, commercial paper is rated. Government regulations may limit who can purchase commercial paper and how much can be purchased by certain entities if the paper has a rating that is less than a certain minimum. Commercial paper is relatively easy to introduce through a specialized exemption. The exemption should recognize the high credit rating of the corporation and the likelihood of institutions being the predominant if not the only purchasers of such instruments.

(f) Capacity Analysis

The Team was informed by CMA officials that commercial paper maturity must be over 15 months to be regulated by the CMA, otherwise it comes under CBE regulations. However, neither the CMA nor the CBE were able to specify which CBE regulations define these criteria. The CBE Sub-Governor confirmed that CBE is not regulating companies issuing any type of securities. This issue needs clarification.

Commercial paper is not issued by banks so it fits squarely under the CMA's jurisdiction, possibly under the definition of "financial notes" under Article 34 of the CML Executive Regulations. CMA will have to determine whether it will require registration of commercial paper, review the CML Executive Regulations to determine applicability and adopt new CML Executive Regulations where necessary. The staff will have to be educated about this new instrument and prepare to review filings by companies, if applicable. The surveillance staff will have to establish

procedures for monitoring the trading of commercial paper, perhaps in cooperation with the CASE.

CASE may have to make changes to its trading system unless commercial paper is traded OTC. Clearing and settlement may require changes at MCDR. Most important, brokers must understand these new instruments and any restrictions that may be imposed on who can purchase them.

5. Derivatives

During interviews the NASD/EFS Team consistently heard from market participants that the current market is not mature enough for derivatives that derivatives would add volatility to an already volatile market, and that derivatives are too complex for the average Egyptian investor. The NASD/EFS Team agrees completely with this assessment. As noted in this report, much more can be done to expand and deepen the market in Treasury bonds, corporate bonds, and investment funds. All available time and resources should be devoted to making the necessary adjustments to optimize the market in these existing instruments. A growing presence of institutions in the market through holdings of investment funds, greater knowledge of investors on the relative risks of different investments and a more active secondary market in Treasury and corporate bonds will create a more mature environment for the introduction of financial futures at some time in the future.

6. Real Estate Securities

Market participants who were interviewed expressed no interest in the development of securities involving real estate. One firm expressed concern about developing such products given the short comings of the local real estate market, many of which are being addressed by other Tasks under the EFS Project. These problems include difficulty in registering ownership of properties, inability to foreclose if a property is not registered, inability to secure a mortgage on a property sold by a foreigner, difficulty in determining the value and sale price of a property, and many others. These problems strike at the very heart of the real estate market.

Given current conditions, a real estate instrument would be exceedingly risky and certainly not appropriate for individual investors. Accordingly, exploration of possible real estate securities should be deferred until there has been experience with the new securitization products linked to mortgages. In any case, these instruments will be tradable, possibly listed, and subject to CMA's jurisdiction.

SECTION IV IMPORTANT NEXT STEPS FOR CMA

The purpose of the Task was to provide a strategy to CMA for introducing new financial products, if appropriate, and for improving existing products and how they are traded in order to create more active markets. As noted earlier, the overwhelming consensus of the market participants with whom the Team met was that CMA should focus on improving existing products, including Treasury bonds, corporate bonds and investment funds. Many detailed recommendations are included in this report under the NASD/EFS Team Recommendations with regard to actions to enhance the market for these products.

The strategy outlined below includes what the Team believes to be the most important next steps for CMA to take to expand the universe of products and

increase liquidity and investor participation in Treasury bonds, corporate bonds and investment funds.

A. Remove barriers to competition to promote product growth and build liquidity

1) Enable brokers to buy and sell Treasury bonds as agent for their customers in the secondary market.
2) Authorize brokers to make markets in corporate bonds.
3) Promote implementation of market making in government bonds by PDs and licensed bond dealers.
4) Authorize investment managers and brokers to act as sponsors of investment funds.
5) Approve and implement standard REPO agreement.
6) Prohibit positioning of corporate bonds by underwriters (i.e., banks and brokers) in offerings that are oversubscribed.
7) Mobilize brokers to actively educate corporations about the advantages of issuing corporate bonds and to underwrite such offerings.
8) Address legal, regulatory and knowledge barriers to expanding institutional investments in investment funds.

B. Address jurisdictional gaps and overlaps between CMA and bank regulators to provide functional regulation and effective oversight of all market participants.

1) Establish high level inter-agency regulatory working group to address the jurisdictional issues and provide for on-going information sharing, with these objectives memorialized in a MOU.
2) Ensure that securities intermediary activities of banks are regulated in the same manner as non-bank intermediaries.
3) Assign responsibility for inspection of PDs regarding secondary market activities in Treasury bonds.
4) Assign responsibility for surveillance of secondary market trading in Treasury bonds.

SECTION V ANCILLARY ISSUES

Other issues not strictly related to the primary objectives of this Task arose during the interviews and the Team's research and analysis of the present trading environment and regulatory framework. These issues are highlighted because the Team considers them to be very important to the continued development of the Egyptian capital market.

1. Clear Delineation of Regulatory Authority

As became abundantly clear during the Team's review of the primary and secondary market in Treasury bonds, the present regulatory framework fails to provide supervision of all securities intermediation functions performed by banks, e.g., quoting and trading government bonds in the secondary market, executing customer orders in stocks and investment funds, and underwriting corporate bonds

and equities. While the CMA has the authority under the CML and the CML Executive Regulations to both license and monitor activities of securities intermediaries, its authority to regulate banks' securities activities is considerably less.

This lack of jurisdictional clarity should be resolved by establishing a regulatory scheme which embraces functional regulation as a core principle. Functional regulation means simply regulation by function. Under functional regulation all entities performing securities intermediary activities as defined in Article 120 of the CML Executive Regulations would be required to comply with the same requirements. Functional regulation recognizes that many different kinds of organizations licensed and organized under different laws and overseen by multiple government agencies perform similar functions. Rather than having multiple government agencies overseeing similar activities, the law provides one agency with expertise and authority to oversee all types of organizations performing a similar function. This functional approach to regulation evens the playing field and eliminates the regulatory gaps that are present in the Egyptian Capital Market today.

2. Clarity and Transparency in Rulemaking

Several examples of the lack of clarity in the CML Executive Regulations are noted elsewhere in this Report. Those examples, of course, only pertain to areas that were the subject of this study. Confusion and lack of clarity in the CML Executive Regulations appear to be a significant problem. In the near future, it is recommended that CMA should embark on a complete re-write of its CML Executive Regulations. This re-write will enable CMA to provide clarity by consolidating, where needed, the regulatory changes that had been implemented through Ministerial Decrees, CMA Board decrees or CMA staff directives since 1992 and incorporating the significant number of new rules that have been recently adopted. In addition, it will provide the opportunity to address the inconsistency of Chapter 7 (bond dealers) with the PD Decree and reconcile the inconsistencies between the requirements for open end versus closed end investment funds, among others. This re-write should include definitions of key terms that appear throughout the CML Executive Regulations, for example financial notes, security, dealer, shares, and promissory note. And, finally, the CML Executive Regulations should be re-written to provide clear guidance on what is prohibited. This will change the common perception that if the law does not authorize a particular practice, then it is prohibited. Removing this uncertainty from the CML Executive Regulations is critical to the further development of the Egyptian capital market.

The NASD/EFS Team believes that some of the confusion expressed by market participants over the applicability of various CML Executive Regulations is due to a lack of transparency in the CMA rule making process. By transparency the Team means a well-known, consistently applied, and open process by which the CMA solicits comments from the general public on all major proposed rules.

We understand that the current practice of the CMA in developing rules is to confer with a specific organization such as ECMA as an advisor during the drafting process. CMA has public members on its Board of Directors (two of whom are from the industry) and it may view this as sufficient to satisfy the need for input from the public. The Team believes these steps are insufficient in terms of broadly soliciting both industry and public comment on rule proposals. Indeed, not conducting a broad solicitation may lead to the adoption of a rule that is unworkable or can't be

implemented from a compliance point of view. In order to avoid these unintended consequences, the Team believes the CMA should implement a true public comment process before it adopts (or materially amends) any rule.

A public comment process would achieve the following:

- Inform market participants, market institutions like CASE and MCDR, and institutional and retail investors about proposed changes to the CML Executive Regulations;
- All such entities and individuals would have an opportunity to comment on the proposal if they so choose;
- CMA would have the benefit of learning whether the proposed rule change will have any impact on market participants and the public or institutional investors, if applicable;
- The process will elicit alternative approaches to the proposed rule change that CMA can consider;
- If followed consistently, market participants, including associations like ECMA and EIMA, will learn to use the comment process to inform CMA of their views;
- Make the CMA rule making process completely transparent.

Once comments have been received on a proposal, CMA should revise the rule change in response to the comments, if appropriate, adopt it and release it broadly to the public. It would be ideal if CMA incorporated into this release an explanation of why certain changes proposed by commenting parties were not adopted, particularly when there has been significant opposition to a particular provision. This open approach confirms to the industry that all relevant comments were considered and specifies the CMA's rationale for the rule as adopted.

3. Self Regulatory Organizations

There is a growing interest in forming "self regulatory" organizations (SROs) to represent the many different constituencies in the Egyptian capital market. The main candidates are ECMA, EIMA, and PDA. For the most part, the early initiatives of these organizations have focused on setting professional standards of conduct, codifying/upgrading business conventions, and sponsoring training. None of these organizations, however, has been vested with authority to inspect or monitor their members' compliance with the applicable standards, and to impose sanctions upon finding instances of non-compliance. If we look to the attributes of a SRO under the US securities laws, every entity recognized as a SRO possesses delegated authority from the Securities and Exchange Commission (SEC) to set and enforce standards of conduct along with the powers to inspect and discipline. Unless an industry organization has standard setting, monitoring, and enforcement powers, it cannot be characterized as a SRO under the US model (or the European model).

The NASD/EFS Team is supportive of the development of SROs and with CMA partnering with them to accelerate development of the Egyptian capital market. This is reflected in Section III in this Report where the NASD/EFS Team Recommendations include many actions to be taken by these organizations with some form of involvement by CMA as well. Going forward, the question is how will these organizations (ECMA, EIMA, and PDA) grow and be funded, given the relatively small sizes of their potential memberships.

The Team recommends that CMA, together with ECMA, EIMA and PDA, explore the feasibility of their forming a single SRO by consolidating all of them into one organization. This approach would be consistent with the initial formation of the NASD, which has an extremely diverse membership. In the case of the NASD, it is governed by a Board of Directors consisting of certain members who effectively represent all segments of the industry. In addition to the Board, there is a structure of Board committees made up of representatives of each of the various constituencies, often delineated by product category (e.g., mutual funds, variable annuities, or bonds) or subset of members (e.g., representatives of small brokerage companies or market makers). These committees have a significant role to play within the organization. More specifically, the committees conduct studies, stay abreast of new developments affecting their constituents, and assess the need for new rules or changes to existing rules to keep pace with new products and strategies in the marketplace. With minor exceptions, no new or amended rule can be considered by the NASD Board until its adoption has been recommended by the appropriate Board committee.

The NASD is an example of an SRO that serves the diverse needs and interests of many different kinds of industry participants. This model would have certain advantages in the Egyptian market. Accordingly, the NASD/EFS Team recommends that the leadership of the CMA and that of ECMA, EIMA, and PDA consider this conceptual approach to forming a comprehensive SRO. On the other hand, if these organizations essentially want to act as advocacy groups for their constituents then they should not seek designation as an SRO.

4. Public Awareness

With the assistance of the previous USAID-funded Capital Markets Development project, CMA expended significant effort on raising public awareness of the capital market. Given this prior focus, the NASD/EFS Team believes that CMA should call upon market participants such as underwriters, investment managers and brokers to take the lead on the next educational phase, particularly as it relates to institutions and corporations. Some strategies are noted above under Section III NASD/EFS Team Recommendations.

A successful public awareness strategy launched by the Latvian Securities Commission may be an effective initiative for CMA to consider for Egypt. The Commission established a weekly radio program that was patterned on the very successful Public Broadcasting System's "Wall Street Week" program in the U.S. The radio program in Latvia featured educational discussions targeted to the average citizen and included a call-in segment which was very successful. The radio time was donated as a public service by a government-owned station. The program required development of program themes, arranging for guest speakers, and analyzing listener input.

5. Economic and Statistical Research Function

The continued growth and development of the Egyptian capital markets will put an increasing strain on the CMA's ability to evolve its regulatory framework to keep pace. In some instances, proponents of new products will seek exemptions from or modifications to existing regulations. The CMA may find instances where one group of market participants claims that a proposed regulation will adversely impact their business or create an unfair advantage for certain of its competitors. To deal with challenges to proposed rules, it will be important for the CMA to be able to

perform its own research and statistical analyses to justify a proposed course of regulatory action.

In this regard, the Team's experience in data gathering for this project is illustrative. To provide background for the Team's field interviews, NASD/EFS Team gathered statistics and other information on existing markets and instruments. After reviewing this material, the Team found that it had received statistical information from the CMA that did not match similar statistics from CASE, EIMA, and ECMA (e.g., number of investment funds, number of outstanding corporate bonds, and number of outstanding government bonds). Availability of accurate and complete information on industry participants and tradable instruments are among the key elements of statistical information that a regulator needs to perform its job.

With this scenario in mind, the NASD/EFS Team recommends that the CMA formulate and implement a strategic plan to: (i) identify and catalog the critical elements of information that must be captured in electronic form for research and monitoring purposes and (ii) form its own research unit to support rule making and other policy decisions that materially impact the securities industry.

6. Focused Enforcement Efforts

The Team understands that the CMA has received over 4,000 customer complaints and this has raised concerns about the integrity of certain brokers that are currently licensed by CMA. CMA has recently raised the capital requirements for new brokers and intends to implement these requirements for existing brokers over the next year which will have the effect of limiting their business activities to match their capital. Meanwhile, the CMA must respond to patterns of problem brokers (and/or broker employees) that may be identified from the customer complaints data.

While raising capital requirements may cause certain brokers to close, those that are forced to close may or may not be the brokers whose business practices are posing regulatory concerns. The Team recommends that the CMA analyze the data contained in the 4,000 customer complaints to develop a list of brokers that will be targeted for causal inspections. The purpose is to allocate the available inspections staff, in the short term, to focus on identifying and brining enforcement actions against unscrupulous brokers. In some instances, the ultimate response may be a sanction and a commitment by the firm to remedial actions. In others, the appropriate response may be to revoke the licenses of the broker due to the egregious nature of the violations found.

The list of firms identified through the foregoing analysis of customer complaints could be expanded to include other firms that the CMA staff believes pose problems based on intelligence from other sources. The CMA inspectors, organized into a Task Force, should focus only on those areas of the firms operations where there is reason to believe that a serious compliance problem exists. For each of these areas, the inspectors will be charged with obtaining sufficient documentary evidence to sustain a successful enforcement action. As a general rule, the greatest emphasis should be placed on business practices or conduct that caused pecuniary losses to investors.

This Task Force approach has been utilized by the NASD on several occasions, including against perpetrators of penny stock fraud. As a result of the organized and focused approach, the NASD was able to take enforcement actions against a number of firms who are now out of business.

Annex:

Schedule of Meetings

Date	Day	Time	Meeting with
27 April 2006	Thursday	10:30 am	Mr. Khaled El Taweel Chairman & Managing Director Counsel Brokerage Company Board member of Cairo & Alexandria Stock Exchanges
27 April 2006	Thursday	12:00 noon	Dr. Mohamed Taymoor Chairman Egyptian Capital Market Association (ECMA)
27 April 2006	Thursday	03:30 pm	Ms. Amani Hamed Chairman Okaz Stock Brokers & Investment

30 April 2006	Sunday	10:00 am	Dr. Mohamed Afifi Head of Fixed income Securities Unit Mr. Mohamed Molazem Head of Corporate Finance Sector CMA
30 April 2006	Sunday	12:00 noon	Mr. Ahmed Nassar Head of Mutual Funds Unit Mr. Mohamed Molazem Head of Corporate Finance Sector CMA
30 April 2006	Sunday	2:00 pm	Mr. Alaa Amer Deputy Chairman CMA

2 May 2006	Tuesday	11:00 am	Mr. Salman Butt Chief Financial Officer Ms. Dalia Khorshid Group Corporate Treasurer Orascom Constructions & Industries
3 May 2006	Wednesday	10:00 am	Mr. Sahar Salab Deputy Chairman Mr. Rafik Madkour Chief Dealer Mr. Sameh Khalil Deputy Chief Dealer CIB
3 May 2006	Wednesday	2:00 pm	Mr. Maged Shawky Chairman Cairo & Alexandria Stock Exchange

3 May 2006	Wednesday	4:00 pm	Mr. Yasser El Mallawany Chairman Egyptian Investment Management Association Mr. Khalil Nogium Vice Chairman Ms. Racha Hassan Executive Director
4 May 2006	Thursday	10:30 am	Mr. Mohamed Asaad Director, Primary Dealers Department Ministry of Finance
4 May 2006	Thursday	1:00 pm	Mr. Mohamed Abdel Salam Chairman Misr for Clearing, Settlement and Depository Dr. Tarek Ezzat Abdel Bary Managing Director

7 May 2006	Sunday	10:00 am	Mr. Atef Ibrahim Sub Governor Central Bank of Egypt Mr. Rami Aboul Naga Consultant, Foreign Department
7 May 2006	Sunday	1:00 pm	Mr. Omar Radwan Vice President Mr. Nabil Moussa Asset Management Director HC Securities & Investment